

January 27, 2005

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**Re: Public Comments on Advance Pricing Agreement Program
IRS Announcement 2004-98, 2004-50 I.R.B. 983**

Dear Messrs. Korb, Hicks, and Frank:

These comments are submitted on behalf of Ernst & Young, LLP ("E&Y"), in response to IRS Announcement 2004-98 (2004-50 I.R.B. 983 (December 13, 2004)) requesting comments on the Advance Pricing Agreement ("APA") Program.

Thank you for the opportunity to comment publicly on the APA Program. Overall, E&Y commends the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") for providing a voluntary alternative dispute resolution program regarding the application of the arm's length standard ("ALS") under § 482. Applying the ALS is inherently fact-intensive and, due to potentially different interpretations of such facts, can result in great uncertainty of the tax consequences of such application for both taxpayers and the IRS, potentially leading to highly contentious controversy.

Prior to the inception of the APA Program, resolving transfer pricing controversies was extremely time-consuming and expensive for taxpayers, the IRS, and the courts.¹ U.S. taxpayers also expressed concerns that U.S. treaty partners would begin aggressively asserting transfer pricing adjustments in reaction to the then new commensurate with income provision, revisions to U.S. transfer pricing rules, and increased IRS transfer pricing examinations. In addition, there were some subject areas (particularly global trading of financial instruments) where IRS officials believed it would be better to develop regulatory approaches to the issues through a cooperative, case by case process rather than through the examination process or through issuing regulations without a full understanding of the industry. These concerns were the principal reasons the APA Program came into existence in 1991.²

The APA Program began with a few taxpayers urging the IRS to change the way that transfer pricing issues were identified and resolved through the traditional controversy process. At first, there were a few test cases involving relatively simple transfer pricing issues in a limited number of countries. Initially, both taxpayers and tax authorities (including senior IRS officials) expressed skepticism that a program based on voluntary taxpayer self selection and voluntary disclosure of information could work.

To say the least, the U.S. APA Program has successfully removed many transfer pricing disputes from the traditional controversy process and significantly reduced the number of Tax Court cases involving transfer pricing. It has become a model alternative dispute resolution process for sound tax administration, with many treaty partners adopting APA Programs based on the IRS experience. It was also instrumental in prompting the adoption of the “MAP APA” procedures in the OECD Transfer Pricing Guidelines. In general, the APA process has proven to be very effective. However, we believe that the APA Program stands at a crossroads today, and that the APA Program can be improved.

While the APA Program currently provides a voluntary process in which the IRS and taxpayers may resolve transfer pricing issues for a prospective period in a principled and cooperative manner, we have concerns regarding the overall flexibility of the program. The original objective and purpose of the APA Program was to provide a flexible, problem-solving vehicle for transfer pricing dispute resolution, which, given the amount of taxpayer and IRS resources required to resolve transfer pricing issues, is essential for sound tax administration. Yet, in many cases the current APA Program environment is becoming overly procedural and is losing its flexibility as an alternate dispute resolution process for taxpayers. This lack of flexibility is our overriding concern with the Program.

We recognize that there are potentially competing policy considerations between flexible treatment of taxpayers in some cases and uniform treatment for similarly situated taxpayers in

¹ Not only did taxpayers and the IRS complain about the prolonged and expensive resolution of transfer pricing issues, but also so did judges who tried such cases. See, e.g., *Sundstrand Corp. v. Comm’r*, 96 TC 226 (1991) and *Perkin-Elmer Corp. v. Comm’r*, 66 TCM 634 (1993).

² See generally Rev. Proc. 91-22, 1991-1 C.B. 527.

other cases. We believe that the proper role for uniformity is with regard to principles. For example, there should not be one rule for foreign owned companies operating distribution and marketing companies in the U.S. and another rule for similar operations conducted outside the U.S. by a U.S. multinational enterprise (“MNE”). Nor should there be one rule for bilateral APAs and another for unilateral APAs.

In most cases, the choice of a TPM or of comparables is based on analyzing the functions, risks and intangibles of the related parties. Inevitably, there are variations in business operations and structures from company to company in every industry. A flexible problem-solving process would provide for allowances for such variances in the analysis and resolution of the issues, while retaining uniformity for basic issues of principle.

The reason our taxpayers seek an APA, in a unilateral, bilateral, or multilateral context, is to achieve certainty with respect to the tax consequences of its transfer pricing policies, and to make certain the relevant tax authorities agree on the application of the ALS to their facts and circumstances. Certainty is the only reason companies will voluntarily reveal sensitive information to be scrutinized by the IRS, and often, a treaty partner: they wish to avoid the potential lengthy and expensive controversy process defending their good faith attempt to apply the ALS.

Many taxpayers in the APA Program have been concerned of late that in its effort to conduct due diligence of their APA requests, the APA teams are treating the process less like a “flexible problem-solving process” and more like a contentious IRS audit. Our experience is that APA teams often request irrelevant information, ask for information contained in the APA submission, ask for information supplied in response to earlier questions that have not been read, and impose rigid or novel litigation-type interpretations of the § 482 regulations to their cases. Not only does this behavior lengthen the time to conclude an APA, but also it often leaves taxpayers disenchanted with the APA process. In many cases, we have received comments from taxpayers that they would rather risk an IRS audit in the future than seek an APA or, in some cases, renewal of their APAs, because they believe that the results of applying for an APA would be worse than the results of the traditional examination process.

We are concerned that if the APA Program continues along this path, it will discourage taxpayers from seeking an APA, renewal or otherwise. This could cause a throwback to the days of long-drawn-out, highly contentious transfer pricing disputes and a Tax Court docket dominated with transfer pricing cases. We recommend the APA Program establish a “Mission Statement” that is consistent with the IRS Mission Statement and takes into account the purpose of the APA Program.

The additional observations and comments below are a composite of feedback we received from MNE taxpayers as well as E&Y professionals. As such, we believe our comments reflect “real life” practical issues with the APA Program.

Below we briefly discuss some of the concerns and suggestions and raise additional points to consider. It is our hope that Treasury and the IRS will modify aspects of the APA Program to offer more balance and flexibility. This will give MNEs a cost effective and timely process to achieve more certainty in their transfer pricing positions than the current program provides, while still achieving the government’s goals of fairness, consistency, and quality.

Accessibility of APA Program to Taxpayers

Although the APA Process is easily accessible to taxpayers, we would like to point out a few procedures that could be improved.

Informal Pre-file Meetings: One of the most beneficial features of the APA process is the accessibility of informal pre-file meetings to define and refine the issues for resolution. The informal meetings are crucial for the taxpayer in identifying all appropriate issues, and equally crucial for the Service for attaining efficiencies in managing the issues and allocating appropriate resources for the case. Despite these benefits, some team leaders have placed a limit on the number of informal meetings allowed for taxpayers that have multiple and complex issues. Since the initial objective in creating the APA Program was to provide a flexible environment to resolve transfer pricing issues by working with taxpayers to identify and resolve complex issues, we believe efficiencies would be gained if the number of informal meetings were not limited in number and scope, and the appropriate IRS principals were in attendance (i.e., Competent Authority representative, industry expert, etc.). In addition, participants should be required to read and analyze any material submitted prior to the pre-filing meeting so that there can be a meaningful exchange of information.

Furthermore, when the taxpayer utilizes the pre-file process and subsequently makes its formal APA request, we suggest it would be much more efficient to assign, when possible, the same team leader to both the pre-file meeting and the APA case. Likewise, if there has to be a change in the team leader at any point during the case, the new team leader should be involved in at least two transition meetings. In addition, team leaders should prepare a memorandum explaining the issues discussed and any tentative resolutions or suggested courses of action. This memorandum should be shared and reviewed by the taxpayer to avoid possible misunderstandings about what was said by either party.

User Fees: The criterion for determining the user fee is overly complex and subjective. One way to improve the calculation of user fees would be for the APA Program to issue examples of fee calculations along with refined definitions of the key terms in interpreting the examples, such as “non-routine renewal” and “separate APA request.”

We have some concern that recent interpretations given to the filing fees section of Revenue Procedure 2004-40 will discourage Small Business Taxpayers (SBTs) (or those slightly above the relevant SBT criteria) from making an APA request due to the relatively high cost. For

example, where the U.S. Company has relatively low gross revenues, a potential \$25,000 or \$50,000 filing fee can appear exorbitant. We suggest this concern be taken into account in any guidance issued by the APA Program. We also suggest that the fee structure be simplified by using a two or three tiered fee structure.

User Fees and Funds Available for Processing the APA Request: Taxpayers are required to pay fees for prospectively resolving potential tax controversies, but filing fees become part of the general funds, not earmarked for processing APA cases. We do not believe that APA filing fees should be used directly to fund the APA process. Given the voluntary nature of the process, there are too many possibilities of parties misunderstanding and linking APA results with fees to justify the additional money that might be used to fund the program.

We strongly believe that the APA Program needs additional funding and resources. In too many instances, important site visits required of APA Program team members to gain understanding of a taxpayers' business and industry have been cancelled due to lack of appropriate funding. Furthermore, funds to hire, pay, and train APA Program staff have not been made available. As discussed below, retaining skilled staff has become a serious issue, resulting in the remaining team leaders and economists being overwhelmed with cases, creating delays and other problems that would be greatly helped by additional staffing funds being made available to the Program. Simply put, the APA Program needs more funding to relieve these problems and other resource constraints discussed below.

Electronic Mail (E-mail) Communications: The current policy of prohibiting the IRS APA team from sending electronic mail ("e-mail") to taxpayers should be changed. Allowing and encouraging the use of secure e-mail communications between taxpayers (or their representatives) and the APA Program would make the flow of information more efficient and speed case communications.

Timeliness and Efficiency in Handling APA Matters

Case Plan and Written Communications: The APA team Leaders are to be commended in managing multiple cases simultaneously. The APA team leaders have been consistent in providing taxpayers with an initial case plan outlining the APA process and the expected timeline and milestones to be attained. However, when there is a deviation in the timeline, or when a milestone is not reached, the case plan is typically not revised nor is the reason for the delay communicated to the taxpayer or to the APA Director.

We recommend that to enhance timeliness and efficiency in handling APA matters, that any reasons for deviations from the case plan (along with recommendations to get back on track) are communicated in writing, along with a revised case plan, to the taxpayer, the branch chief and the APA Director. This accountability (on the part of the taxpayer and the APA team) will enhance efficiency in timely processing the case and identifying and resolving possible process issues.

We recognize that the APA Program is experiencing resource constraints. However, when the lack of resources is the primary reason for lack of progression in a case, we recommend advising

the taxpayer of this fact in writing along with a revised, realistic case plan. Taxpayers get very frustrated with the Service's lack of timely communication or of delays when they are held to a higher standard.

In addition, the taxpayer must provide exhaustive documents detailing all facts, positions, and reasons for proposing those positions, as well as written responses to requests for additional information. However, it has been our typical experience that when the APA team makes a determination to reject or modify a taxpayer's proposed position, nothing in writing is supplied in the vast majority of cases. We recommend that the IRS deal with the taxpayer with the same respect that it requires, that is to provide all requests, determinations, decisions, and positions taken and its reasoning in writing that includes the reasons for IRS positions and any analysis used by the APA team. By providing written communications, the process will increase understanding of each side's rationales, clarify interpretations, manage expectations, and provide greater timeliness in responses.

To provide a common example, when the taxpayer submits a set of comparable transactions to the IRS, it must also provide and defend the methodology used in choosing that particular set, as well as the reasons for excluding other comparable transactions (i.e., a comparables selection and rejection matrix with reasons why). However, when the IRS challenges the taxpayer's selection and chooses an alternative set of comparable transactions, it very rarely provides the taxpayer any reasoning for choosing that particular alternate set, nor the reasons behind excluding other comparable transactions, despite requests for such an explanation. Taxpayers are left with a perception of "take it or leave it" – this is not the flexibility the Service wants to promote.

Furthermore, with respect to IRS requests for information during the APA process, some team leaders act as a filter for the various questions posed to taxpayers from the APA team members, including the economists and field representatives, while others merely send forward whatever certain team members request. Many taxpayers have been required to provide the same information numerous times. In a great number of cases, the information requested was set forth in the text or the exhibits to the APA submission. In other cases, the questions asked have been irrelevant to the issues and demonstrated a lack of familiarity with the submitted materials. Team leaders need to be sensitive to the waste of time and increased cost for taxpayers to respond to irrelevant or previously answered questions by not only being familiar with the materials already submitted by taxpayers, but also by actively filtering and managing the information flow of their teams and cases.

Caseload Management: The report to Congress on the caseload status of the APA Program is provided on an annual basis. The APA Program Annual Statutory Report benefits taxpayers in many ways including reviewing the APA caseload with the available IRS resources to work on that caseload, to gauge a realistic probability of case progression. For the taxpayers participating in the APA process, it would be beneficial to know that the branch chiefs and the APA Director are aware of caseload management issues more often than once a year. We have experienced instances where there has been a breakdown in communication between the branch chiefs and the APA Director regarding caseload management issues. We suggest that part of the case plan include providing a quarterly status update to the APA Director. This status update will alleviate surprises and manage expectations of the APA team as well as the taxpayer.

Beyond providing case status reports, the branch chiefs and APA Director should be more actively involved in moving cases along in the process. Too often cases have languished with certain team leaders without any apparent effort on the part of APA Program management to get their cases moving to completion. LMSB and other IRS offices have procedures and policies in place to assure cases move forward (e.g., more active review, regular internal meetings, an emphasis on productivity in evaluations, etc.), and we encourage the APA Program to consider implementing such appropriate methods to help reduce case completion time.

Furthermore, recognizing a change in APA case management in recent years, we understand that APA team leader decisions are often communicated to a centralized manager before they are discussed with the taxpayer. This case management process slows case progression. We have experienced team leaders “working” cases to satisfy their branch chief’s perceptions instead of understanding the taxpayer’s facts and issues and resolving projects in a mutually acceptable manner. There have also been instances where technical or material decisions reached with team leaders have been changed by branch chiefs, resulting in a loss of credibility for the team leaders and the APA Program with taxpayers. We suggest that branch chiefs become involved earlier in cases, for example, participating directly in the discussions with taxpayers regarding technical issues or other issues that will assure timely case resolution.

Coordination with Competent Authority and Technical Advisor: The input and contributions of Competent Authority representatives are crucial to the success of bilateral and multilateral APAs. They provide guidance on the intricacies of foreign tax authority positions that should guide IRS and taxpayer positions taken in an APA. Their input and guidance is essential to the success of the APA Program.

In the past, Competent Authority representatives were part of the initial APA team, and the taxpayer and the APA team benefited from their input and expertise. Recently, Competent Authority representatives apparently have not been invited to be part of the initial team, but instead have been consulted near the end of the IRS/taxpayer negotiations. Since the APA team may not be aware of foreign tax positions, this puts the taxpayer and Competent Authority representative at a disadvantage in negotiations with the foreign tax authorities. Therefore, we recommend that the inclusion of Competent Authority as an active APA team member at the beginning of every bilateral and multilateral case be reinstated as a clear policy.

In this regard, we recommend the inclusion of team leaders as case advisors in the Competent Authority negotiations under normal circumstances. During the course of developing a recommended negotiating position, the team leader should become intimately familiar with the taxpayer’s relevant business operations and financial data. In addition, as the drafter of the negotiating position paper, the team leader is in the best position to explain the APA Program’s analysis and rationale for the APA terms. This potential case resource of knowledge and understanding would be extremely helpful to fostering bilateral agreements. In addition, active participation by the team leader in the Competent Authority process would help to alleviate the practice where team leaders recommend unrealistic positions which the Competent Authority analysts knows will not be sustained in Competent Authority negotiations.

Furthermore, we suggest that a § 482 expert regularly be part of the APA team. Such experts could be a member from the Field, Chief Counsel, or Appeals office. Adding such a member to the APA team will promote sounder application of the Treasury Regulations and OECD Guidelines, and provide leverage in Competent Authority negotiations with foreign tax authorities in bilateral and multilateral situations. In the alternative, we recommend APA Program team leaders and economists be developed consistently as § 482 experts, and that they have ongoing and regular § 482 training. Several years ago, such a training program was instituted for the APA Program staff, but it appears to have been dropped.

Mediation, Field Service Advice, and Technical Advice: There are times when cases do not progress for reasons beyond taxpayers' control. If a case is not progressing in a timely fashion, the taxpayer should have the option to seek mediation with APA Program management. We recommend that an APA request be processed within twelve months at the APA team level, and if no agreement is reached, then the case automatically becomes the responsibility of the branch chief for another 90 days to reach agreement. If no agreement is reached with the branch chief, then allow 90 days for the APA Director to mediate a resolution of the case. Conversely, when the case is not progressing because the taxpayer and IRS cannot agree on legal issues, the taxpayer should have the ability to seek Technical Advice on the disputed issues with someone outside the APA process (an issue or industry specialist, or possibly an outside independent expert).

APA Renewals: After a significant commitment in time and expense on the part of the taxpayer and the IRS in securing an APA, we suggest that, when possible, it would be more efficient to assign the original team leader to the request to renew that APA. This has not always been the case, even when the original team leader is still within the APA Program. Moreover, there should be a strong preference to renew APAs based on similar terms or comparables taken from the prior APA when the facts remain substantially the same for the renewal years.

Unpublished Transfer Pricing Concepts, Methodologies, and Policies: While we commend the IRS and APA Program in its search for innovative resolutions to potential transfer pricing issues, we recommend that experimenting with "new" and "unpublished" litigation-type concepts, policies, or interpretations of the existing regulations be stopped. We have experienced APA teams proposing methodologies that are not substantiated or founded in the principles of the Treasury Regulations or OECD Guidelines. This is very unsettling. Taxpayers who enter the APA Program should be held to the application of the same standards, methods, and interpretations as taxpayers who do not enter the APA Program. Moreover, until positions are sustained in court, published in regulations or rulings, or generally accepted by treaty partners, taxpayers should not be required to follow untested or undeveloped positions as a condition for obtaining an APA.

Unilateral and Bilateral APA Treatment: We have experienced APAs in which taxpayers receive different treatment depending on whether the APA is bilateral or unilateral. For example, the inability of taxpayers with unilateral APAs to apply a rollback in which U.S. income would be reduced. We recommend the APA Program reconsider this policy. While there are limitations on a taxpayer's ability to use § 482 to reduce U.S. income once an original return has been filed, there is no legal restriction on the IRS granting a refund when the IRS determines that the

taxpayer has over reported income. If the APA Program wants to discourage inappropriate transfer pricing manipulations, it should not be discouraging taxpayers that are making a good faith effort to report a reasonable amount of taxable income in the U.S. More broadly, the APA Program should ensure that taxpayers who choose to enter into unilateral APAs are treated consistently with taxpayers who enter into bilateral APAs.

Rollbacks: The ability to apply the agreed upon methodology to prior tax years (rollbacks) is a favorable feature of the APA Process. However, the reality is that because of perceived intra-agency “turf” battles, rollbacks are becoming less available. The rollback decision is supposed to be based on whether the facts and circumstances between the years covered by the APA and the potential rollback years are sufficiently similar that the same TPM and comparables should be applied. However, in many cases, the rollback decision is based solely on whether applying the TPM produces the desired adjustments for the earlier years. We recommend that within 30 days after the taxpayer responds to the first round of IRS questions, the taxpayer be notified in writing whether or not a rollback “in concept” will apply to the APA. If the APA team does not want to agree to apply the APA terms in principle to the rollback year, the letter should identify the facts or circumstances that the APA team has identified that do not warrant applying the same TPM or the same comparables.

Particular Industries

Publish Optional Safe Harbors: The APA Program has matured and gained expert knowledge of certain industry practices and processes. In an effort to streamline the APA process, we have experienced a tendency for the APA team to analyze and position taxpayers in an industry similarly, e.g., a one-size-fits-all approach. We understand and commend the IRS in its efforts to leverage past analyses of similar taxpayers to simplify the process, but argue that insistence on this type of consistency may not be the most flexible or efficient manner for all taxpayers in an industry given the inherent factual nature of every taxpayer’s operations, even if in the same industry. We recommend that if the APA Program wants to treat taxpayers in certain industries similarly, that optional safe harbor analyses and results be published (e.g., with the APA Program Annual Statutory Report). In this manner, taxpayers have the option to choose to follow the safe harbor guidelines, or pursue a determination outside the safe harbor. Although we commend the IRS in its efforts to be more efficient, we recommend that if consistent treatment is to be applied, it should be focused on applying consistent principles in the APA process, not the mechanical, consistent execution of similar analyses. There should be flexibility in applying consistent principles to reflect unique business and economic facts and circumstances.

Small Business Taxpayer APA: The Small Business Taxpayer (“SBT”) APA can provide a cost-effective channel for small taxpayers to work together with the IRS to gain certainty in their transfer pricing practices. The SBT APA is marketed as a quick process because the taxpayers and transactions are smaller in volume and revenue. While that may have been true when the SBT procedures were first implemented, now we have observed that the amount of effort required to obtain an APA is in many cases the same for a small taxpayer as it is for any sized taxpayer – there is no less work for the APA team for a small taxpayer than for a large taxpayer, and small taxpayers typically undergo the same questioning process (discussed earlier) as larger

taxpayers. Currently there is limited procedural benefit for a taxpayer to file under SBT APA process.

We recommend that the process for obtaining an APA for small business taxpayers be taken seriously by the APA Program by honoring its commitment to have an expedited and simplified process. It may be appropriate to select particular team leaders and economists to handle exclusively the SBT APAs, or it may be feasible to select a SBT coordinator to assist in processing these cases, but however the problem is resolved, it clearly needs to be addressed.

Effectiveness of APA Program for sound tax administration

Resource Issues: The professionals in the APA Program are dedicated officials and provide a valuable service to taxpayers and the IRS. They show interest in learning about taxpayers industries and businesses in order to fairly and flexibly apply the rules to the unique facts and circumstances of individual taxpayers. To be effective in analyzing the technical transfer pricing issues, and to be on top of the case management and communication challenges, requires a high degree of skill, talent, and expertise. Unfortunately, it is widely recognized that the APA Program is experiencing problems in retaining its most talented professionals, and difficulty in recruiting new professionals. A number of former APA Program members concur that Treasury and the IRS need to focus on building the support for this Program by allocating greater fiscal resources to its operation, and by instituting an aggressive incentive program.

First, we recommend that APA team leaders be elevated in rank, either to working grade 15s or to a special alternate pay scale. Second, we recommend that an incentive program for management personnel be linked to management's ability to retain professionals. Third, the incentive program should be linked to meeting milestones in taxpayer APA cases. We believe that an incentive program with these attributes will foster a positive work environment, initiate innovative ways to stay on track to meet timelines and milestones, and provide management a means to reward effectiveness and taxpayer service in the APA process. Fourth, the APA Program should hire staff to assist the team leaders or economists to perform routine work such as project management, routine database searches for comparables, and other activities that do not require the expertise of a specialized team leader or senior APA economist. Lastly, we recommend that recruiting objectives for the APA Program should be continually reviewed to ensure a good combination and mixture of talented and experienced transfer pricing professionals.

Features of the Standard APA Contract

The standardized APA Contract fulfills its objective as an agreement between the IRS and the taxpayer regarding transfer pricing methodologies.

Updating the Arm's Length Range to Reflect Events During the APA Term

As a theme that resonates throughout these comments, flexibility needs to return to the principles of the APA Program. As such, we recommend that the need to update the arm's length range

during the APA term should remain flexible, not a requirement, depending on the business and economic facts and circumstances of the taxpayer.

Other Considerations

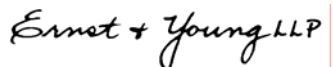
We recommend certain discrete points regularly be clarified between the APA Program and the IRS Field at the start of the APA process. Specifically, which years each function has jurisdiction over, i.e., what is prospective versus rollback. We have experienced cases in which the Field appears to control inappropriately the resolution of APA years, where the principle of a rollback is to apply the APA TPM to past years, rather than the other way around. Additionally, we recommend clarification at the start of each APA case that the taxpayer's non-factual representations made during the APA process may not later be used in a manner prohibited by Revenue Procedure 2004-40. The emphasis on these points at the start of the APA process would go a long way to assure taxpayers of the integrity of the APA process.

Conclusion

Ernst & Young LLP appreciates the opportunity to provide these comments, and thanks Treasury, the IRS, and the APA Program members for their consideration of the foregoing comments. Please direct any further questions to the tax professionals below.

Respectfully submitted,

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